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TOWARD A FISCAL AGENDA FOR MINNESOTA

Never in living memory has government in Minnesota been in worse financial shape. It appears that for the current biennium (1981-83) projected expenditures exceed revenues by hundreds of millions of dollars, despite the stopgap legislation enacted into law this month. And this is not a passing distraction; in all likelihood huge imbalances will recur biennially into the indefinite future. In the ongoing fiscal debate some are tempted to ignore the long run; others, correctly perceiving that there can be no universally popular solution, have taken to blaming one another rather than be associated with any substantive action in the short run. Citizens have joined in, attributing the problem to character defects in politicians. None of that helps. Meanwhile there is "no comprehensive agenda" being debated, much less implemented. This paper is a step toward the creation of a fiscal agenda for Minnesota--for a prosperous and humane Minnesota.

The paper is in four parts. First the current debate is summarized. Next there is a discussion of why the terms of that debate are inadequate; neither side offers persuasive diagnoses of what ails the state's expenditures or its revenues. Third, guiding principles and derivative policy examples are presented for fundamentally reformulating both the way the state spends and the way it taxes. Finally the implications of not adopting thoroughgoing policy changes are presented.

I. The Current Debate

The standard description of Minnesota's fiscal situation runs as follows. Ten years ago the state expanded its revenues greatly to enable regular transfers of funds to school districts and cities. Thus statewide sales and income taxes rather than local property taxes became the predominant sources for local spending. Since Minnesota's income tax is progressive, and inflation persisted throughout the seventies (pushing income taxpayers into higher brackets), vast sums were reaped by the state and returned to local governments (and directly to property taxpayers in the form of credits and rebates). Legislation in 1979 to index the income tax brought an end to the automatic bonanzas for the state. Then, the views diverge; depending on one's politics, the current deficit is blamed either on two successive national recessions or on indexing and related "mismanagement".

Proponents of the first view have been quite successful in persuading the citizenry that government can be cut more or less painlessly in order to balance the budget. A corollary, also widely accepted, is that with a smaller state budget people will have more money available to spend privately, thus returning them to the standard of living they expected before the recessions hit. Implicit, but an important adjunct of this point of view, is the belief that there is an inverse relationship between the levels of personal freedom and public spending. Since those of this persuasion take for granted that society is better off if a dollar is spent privately than if it is spent publicly, cuts need not be targeted but can with benefit come from any part of the budget; across the board reductions are proposed. If increased revenues are necessary they should come from the property tax which hasn't been rising lately unlike sales and income taxes. Finally there is a presumption that lower budgets and taxes will in some way "unleash" the private sector and stimulate the economy.

Opposed is a viewpoint that defends state spending as reflecting a civil and decent society. Opportunities are broadened, personal freedom expanded, by a range of governmental activities; cuts are to be resisted. Besides, state taxes now take a lower fraction of our income than in years past--$89 per $1,000 of income in 1980, compared with $92 in 1974, $101 in 1977. The deficit is to be eliminated largely by raising taxes, especially income taxes, which are progressive in contrast to those on sales and real property.

So here are the terms of the debate: large but painless cuts (with some property tax increases) and an invigorated private sector vs. smaller budget cuts (to protect the needy) along with sizable personal and corporate income tax increases. Both sides reflect inadequate diagnoses of government finance in Minnesota. It is necessary to reformulate the issue, looking more carefully at what has gone wrong with both the expenditure side and the revenue side of state government.

II. The Inadequacy of the Current Debate

1 Government expenditures: necessary but inherently inefficient as now structured

It is in vogue these days to maintain that government doesn't work. If true that would be convenient. For then little would be lost if the budget were balanced by cutting spending. Unfortunately, the explanation for what is wrong with public expenditure programs is more complex. It can be summarized in six observations about a representative government service, special education for handicapped children.

1. In recent years there has been an increase in state expenditures on the schooling of mentally and physically disabled youngsters. That is a mark of a decent society; Minnesota has chosen through its representative institutions to spend incremental resources in this way rather than buying even more electronic toys, Las Vegas vacations, or personal adornments.

True

2. However, on the average, the extra spending on special education has not yielded educational outcomes different from what would have occurred in its absence. This deeply discomfiting fact has been too well established by sophisticated evaluations to be ignored.
3. Nevertheless, the evaluations show scattered instances of very effective special education where children make hearteningly large gains in educational attainment.
4. What is more, the characteristics of the effective programs have been identified. When children are taught in small classes; by teachers who are knowledgeable, enthusiastic and empathetic; in a disciplined environment where lofty

expectations are held for the children; and when the students' "time on task" is high, then these educational programs are effective indeed. That those findings of technical evaluations corroborate common sense makes them no less impressive or useful.

5. In general, were the state to expand--or to cut--its special education budget there probably would not be an appreciable effect on educational outcomes, since school systems would not thereby necessarily be either more or less inclined to implement effective approaches. (It is not difficult to find attitudes toward spending that are unconducive to effective schooling: teachers' organizations that resist the use of uncertified aides to reduce student-teacher ratios; administrators that seem intent on using additional revenues to hire yet more administrators; school boards that continue to operate school buildings which must be heated, lit and swept whether fully occupied or not.)
6. Therefore, special education should be restructured so as to foster use of effective approaches.

These six points probably apply to most items on which the state spends its money. State government in Minnesota consists not of frivolities but of enterprises which are widely held to be appropriate, even crucial. But these activities--state hospitals, aid to education, assistance to the poor, ...--are not characterized by effective mobilization of resources. Able, hard-working and well-intentioned public servants often are prevented by the fact of their working in a bureaucracy from doing their jobs well. Bureaucracies--the usual agents of government--though necessary and valuable, tend inherently to be inefficient.

2 Revenue shortfalls: Long-term stagnation, not short-term recession, is the problem.

The state's inability to generate sufficient revenues goes deeper than the temporary down-turn in the economy. The amount of state revenue depends directly on the value of the goods and services produced here. For the past decade, the value of the goods and services produced in the state and nation has grown much more slowly than previously had been the case. This should be deeply disturbing to all, for the tax increases and budget cuts recently enacted and those currently under discussion are almost entirely predicated on a presumption that the economy soon will snap back, producing a surge of goods and services, and, therefore, a fast growing stream of revenues for the state. But this is polly-anish. Even when our current recession ends, there is every likelihood that the entrenched stagnation will persist.

There are two further factors to consider. In the past, the full effects of economic stagnation have been hidden by federal largesse. As federal aid to states dries up (it is already down 25% this year), the state will be thrown more to its own resources, and the inadequacy of these resources will become more obvious.

Secondly, given Washington's political reluctance to touch entitlement programs and defense, it would take near eradication of the entire remainder of the federal budget (including all aid to states and cities) to bring it out of deficit by 1984. That won't happen of course, but this only means there will be sizable federal deficits for years. Those deficits will require federal borrowing of massive sums, amounts so great as to ~~keep upward~~ pressure on interest rates. And, sadly, high interest rates are part of what causes our present stagnant condition. The state can expect to have serious revenue problems for a long time. Higher or lower state taxes in themselves will not alter this more fundamental reality.

III. Reformulating the Debate

Those who have supported expansion of state government tend to believe that the guiding principle during the current difficulties should be humaneness --and continued application of that principle requires solving problems by raising taxes. Opponents opt for efficiency--and see that as requiring cutting budgets instead of raising taxes. Legislative wrangling has been over the mixture of budget reductions and tax increases. That is a deadend, for not only does it impose suffering on the frail, poor, young and old--to the shame of the rest of us--but it is a stopgap. Handled this way the fiscal issue will recur over and over again in coming years.

There is merit in framing the issue differently; the following makes the attempt. It is necessary (1) to cut the budget, while protecting our commitment to the needy by restructuring programs so as to foster effectiveness, and (2) to raise taxes while doing what we can to stimulate the economy. Again, the way out of our fiscal swamp is not a mere compromise between spending and taxing but a bold revamping of the ways we spend and tax.

Principles for restructuring the budget

Here are six guidelines which could show the way to revamping the budget.

1. Protect those who are needy. Especially when people feel financially pinched, it is a responsibility of political leaders to protect the poor and the defenseless. Basic education, a modicum of income, medical care--these are matters not of largesse but of entitlement and right.
2. Provide money rather than services to the needy. Government itself need not produce services if people have the wherewithal to purchase what they need. This approach is preferable not only because it makes some public bureaucracy--the administration of the service--unnecessary, but also because it is less patronizing, it broadens individual choice.
3. Return institutionalized people to normal lives. As will be shown, the state expends great sums to heal or maintain people outside their homes. It will not be easy to reverse this trend. On the other hand, who would deny that a part of the current societal malaise is the progressive disintegration of our commitment to care for loved ones at home?
4. Foster self help rather than dependence on government.
5. Charge people for public services they receive. If citizens have the

money to pay, then charging for a service what it costs is an inducement not only to produce economically but also to provide only as much as people truly want.

6. Hold service providers accountable, rewarding the effective, penalizing the ineffective. For no good reason, it has come about that government insulates insolvent firms, school teachers, bureaucrats, et. al. from being held to standards. That cannot contribute either to financial health or to confidence in public institutions.

It will have been noted that each of the principles has its limits. Lest the limits distract from the argument it is useful to dwell for a moment on the principles in order, acknowledging their exceptions. (1) Presumably there are needy people who are undeserving of public support; (2) government is not about to give chits to the down and out to buy police protection; (3) of course, there will be those too sick or alone to be cared for at home; (4) dependence on private roads or volunteer militia would not be progress; (5) putting a price on everything government does would be unseemly, if not impossible and (6) sometimes it is difficult to identify who is responsible for government's successes and failures. All that granted, these six guideposts suggest ways out of the current impasse. As with everything, applying the principles is a matter of degree and emphasis. But as will be seen presently, implemented with prudence and restraint, they imply major changes to the way the state does its business.

Restructuring the budget (applying the principles)

What first catches one's eye when studying the Minnesota state budget is the small part that is devoted to the man on the street's favorite targets for cuts--state employees and welfare recipients. Together the two make up only 18% of the budget. (If this month, instead of passing the interim financing bill that moved the state toward a balanced budget, we had fired the entire state government bureaucracy in St. Paul--plus the Legislature, Supreme

Court and Governor--and eliminated AFDC, enough would have been saved to cover only half the projected deficit for the current biennium.) Indeed, it is partly because the main objects of expenditure enjoy widespread approval that budget cutting is so difficult. Six of every seven dollars spent by the state are devoted to three categories of activity: providing care for persons in need by reason of age, poverty or disability; educating young people (which category is customarily divided in two--elementary and secondary, and higher education); and redistributing state tax dollars to local governments and local property taxpayers. It is because much of what is decent and attractive about Minnesota is embodied in these items of expenditure that they must be restructured rather than slashed.

The next step toward a fiscal agenda is, then, to provide a few examples of how each of the expenditure categories might be recast. That is what follows.

Health, Welfare and Corrections (20% of the state's budget)

Providers of medical and nursing home care should be held responsible for cost containment--for example, through use of pre-paid health plans rather than fee-for-service medicine.

Welfare recipients who decline to join such a plan should be required to pay part of the additional costs of whatever alternative form of medical care they receive.

Government's medical assistance should be available to keep aged, retarded, disturbed and drug-addicted people at home, thus making resort to publicly (or other third party) provided hospital and nursing home care less automatic.

If family responsibilities permit it, welfare recipients should be provided job training and jobs--if necessary, public employment.

It should be required that prisoners work to compensate the public treasury for what is spent on maintaining the prisons. A corollary is that conditions be correspondingly spare for those who are uncooperative.

Elementary and secondary education (30%)

Here society faces a fundamental choice that is stark but very possibly unavoidable: Either teachers, administrators, and school boards will accept accountability for the results of schooling (rewarding effectiveness, subjecting ineffective schooling to sanctions); or

Accountability will be returned to families who would use tuition tax credits and/or vouchers to pay for the type of schooling they want.

Higher education (10%)

Basic tuition (the "price" of schooling) in public institutions should be a higher fraction, say 40% or more, of the cost of instruction; but

Tuition should be adjusted by grants and loans to reflect a student's financial wherewithal so that no one is prevented by lack of funds alone from receiving post-secondary education.

Property tax rebates and aid to local governments (25%)

Property tax relief should be made more dependent on need, for example by reducing the homestead credit and increasing circuit breaker benefits.

Local government aid should be dependent in part on a local government's degree of adherence to the six principles; for example, a county government could be granted some of the state's cost savings when the county enrolls medical assistance recipients in a health maintenance organization or when the number of the county's residents who are living in state institutions is reduced.

Throughgoing changes of the above kinds would save hundreds of millions of dollars for the state budget. On the other hand, it is unlikely in the extreme that even such revamping could make tax increases unnecessary.

Principles to guide tax restructuring

Revamping tax policy will be as difficult and necessary as will be changing how the state spends its money. Here too it is helpful to base decisions on explicit criteria. There are four relevant principles for Minnesota in 1982. The first two are the same as numbers 1 and 5 of the six listed above concerning expenditures. For decades, even centuries, ability to pay (1) and benefit received (5) have been contending bases for taxation. There is no need to consider them mutually exclusive. For a service that is not essential or if a recipient can afford its purchase, or both, efficiency considerations suggest that that service be offered at a fee, to induce economy in its production and to insure that no more is produced than the taxpayer-feepayer wants.

A third principle for tax policy, one commonly not systematically applied to state government, is encouragement of economic growth. Although long a consideration in national fiscal affairs, it has had only haphazard application in Minnesota. Democrats have taken the economy for granted--blithely viewing it simply as available to be taxed. Republicans, while claiming an adverse effect of taxes on economic activity, were usually so transparently self-serving in their proposals as to be entirely unpersuasive. (Some of Governor Quie's recent proposals are notable and welcome exceptions.) In a time of extended economic sluggishness it behooves all to consider seriously how taxes affect the level and rate of expansion of the economy.

A final principle, added to the list for pragmatic (i.e., revenue-collecting) as well as equity purposes, is the treatment of loopholes as tax expenditures. A tax expenditure is a loss to the state treasury by exempting something from taxation that would otherwise apply. (Thus the name "tax expenditure", since it is the equivalent of taking in the money, then spending it.) Deduction of charitable contributions and special treatment of capital gains are examples. The notion is not that all money in Minnesota belongs to the government which deigns to allow its citizens to keep a bit. Rather, regular scrutiny of tax breaks as though they are expenditures not only serves the equity of the tax system but also forces asking whether specific treatment of an item continues to serve a public purpose.

Restructuring taxes (applying the principles)

Minnesota has a laudably progressive income tax structure, but it is riddled with loopholes and, though hospitable to certain firms, especially large national enterprises based here, it is generally indifferent to matters of research, development, innovation and investment--the stuff of economic growth. The challenge is to raise needed revenues while protecting the sensible features of our tax code and guiding resources toward productive use for the long run.

Fostering economic growth

The usual political blather about job climate misses the point. Minnesota's long term problem is not joblessness; year in and year out we are near full employment, with an unemployment rate far below the nation's. And too often the short term unemployment--that is real and painful now--is misunderstood or misrepresented by opportunistic politicians. While some firms leave Minnesota, new ones start up here and others move in from elsewhere. The number of firms pulling up stakes and leaving does not vary much state by state across the country. So anecdotes about this firm or that finding greener pastures serve mostly to stir up political passions--except in border cities where there is a real problem.

Furthermore, there is no particular virtue in luring jobs to Minnesota if they are not highly productive, that is, using skilled workers or large amounts of capital per worker, or both. If we are all employed but at jobs in which little of value is produced, are we well off? Minnesota's economic problem and that of the entire country is that for a decade and more we have been laggard in devoting resources to devising and implementing better ways of producing goods and services. Our problem is not disuse of current workers and machinery but devoting insufficient capital to making human and physical resources more productive.

Money can be spent in either of two ways: on consumption or on investment. The former enables satisfying current desires. The latter embodies more effective means of production for the future; that is the way we improve our standard of living. Economic growth can occur only if income is diverted from current consumption, saved and invested. Investment dollars are spent on research--todevise ways of producing goods and services less expensively, and on methods of production that embody those new ways. The state and nation now lag behind other industrial societies because we are not setting aside funds for finding and implementing that better future. The present high unemployment levels will soon pass, but when they do the output--and thus incomes--of the state and nation are apt still to be growing only slowing.

Today many misconstrue the fiscal issue as public vs. private, when on this matter a more crucial distinction is between consumption and investment. In Minnesota there have been numerous instances when public investment--on a range of subjects from plant hybrids to taconite--have led to improved production methods.

Minnesota needs a massive transfer of resources from consumption to investment. That will hurt; it will mean forgoing current satisfaction. But only with investment today can there be larger output--and prosperity--tomorrow. Those who focus on what they call the job climate wrongly impose a short term depression mentality on a long term stagnation issue. There are several actions the state can take to encourage economic growth.

The state should provide very attractive targeted incentives for productive research, development and investment (not including that accomplished merely through acquisitions and mergers).

The criterion to be applied with respect to accelerated depreciation allowances should be: Do they foster productive investment? Minnesota should grant such allowances only for investment that actually takes place in the state (disallowing credits and deductions for investment outside Minnesota but reported on a firm's Minnesota tax form).

Rather than shoring up declining industries, the state should grant sizable tax credits to workers in those industries for investment in retraining. The credits should be refundable, that is payable whether a tax is owed or not.

Where future needs--and present opportunities to meet them--are not being addressed by private concerns, the state itself should invest directly. Research and development on power generation using peat and cattails are current examples.

We should provide tax breaks for saving not for borrowing, for interest earned not interest paid. We should begin by removing the income tax deduction for consumer credit.

Raising additional revenue

Part of the current political dispute is a disagreement between those favoring further use of the income tax because it is progressive, and those favoring some increase in property tax rates because they have been artificially held down and because residents should feel the tax bite of their city's expenditures. There is merit to both sides of that argument. But it is the wrong argument. There are other ways to make taxes progressive, other considerations besides the progressivity of a tax (on whom and for what is the money spent?), other less attractive characteristics of the property tax (its blindness to economic conditions). But there is a larger objection to framing the issue as income taxes vs. property taxes. In great measure that argument is a dispute between advocates of the ability to pay principle and those supporting taxation according to benefits received. Since it ignores the effects of taxes on economic activity it is inadequate as a way to frame the taxation issue. Considering the several principles yields a beginning set of policy prescriptions for raising revenues.

In the future greater use should be made of expenditure (i.e., sales, excise and value added) taxes rather than expanding the income tax. Income saved, and consequently invested, is subject to the latter type of tax but not the former. That is a strong argument against expanding the income tax in these times.

Progressivity of the overall tax structure can be protected by a progressive system of credits on the income tax. (The credits should be paid whether or not the recipients owe any income tax.)

A number of socially unproductive tax expenditures should be reduced or eliminated: for example, capital gains treatment of collectibles, and business entertainment deductions, which have become a national scandal. (Minnesota has never had a systematic survey of its tax expenditures--what they are, who benefits by them, whether they are still justified. It is high time to undertake such a study.)

IV. What Happens if State Expenditures and Taxes are not Recast in this fashion?

Conventional budget practice is to make spending changes incrementally and across the board. This approach has even been blessed by academicians. Textbooks attribute advantages to it: it is easy to do; politicians have no difficulty explaining it; there is the appearance of being equitable. ("All will suffer equally; each will have to carry its share.") There is merit to that when cuts (or increases!) are small or temporary. However, in the current circumstance, where in all likelihood large cuts will be necessary year after year, it is imprudent not to link cuts with more fundamental changes in our ways of carrying out the state's business.

That is because the alternative, annually gnawing away at the state's existing array of activities, would surely leave Minnesota poorer--the civilizing influence of government diminished and the populace even more dissatisfied with their government than they are now. Fewer workers would tend state hospitals that are shamefully spare, while public parks grow seedy, policemen respond more slowly, planning for the future goes undone, streets remain unplowed, students learn less in larger classes. This should be convincing to all who value what government provides and who suspect that economic prosperity--which generates tax revenues--might not be around the corner. And, when government is more efficient, all will find more persuasive the contention that a taxpayer's final dollar might be more productively spent on public purposes than on private.

The taxation side is even more problematic. It is not customary for a state to attempt seriously to influence the productivity of its economy. But who will argue that it should not be tried now? Transferring resources from current consumption, public and private, to investment for longer term growth will be painful. However, it is a kind of belt tightening that makes sense. It offers a better chance for a Minnesota that is both more prosperous and more generous.

Minnesota is not suffering a crisis, it is not facing disaster. Our fiscal problem is serious but it is not to be compared with the travails of Poland, Bangladesh or even New York City. Perhaps it is healthy for a comfortable society to have a worthy challenge, especially when it has the capacity to meet it.